OFFICE OF PROFESSIONAL RESPONSIBILITY
INTERNAL REVENUE SERVICE
Department of the Treasury
WASHINGTON D.C.
March 2, 2006

DIRECTOR, OFFICE OF
PROFESSIONAL RESPONSIBILITY
Complainant

COMPLAINT NO. 2004-11

v.

Thomas Edward Settles
Respondent

DECISION

Appearances: Gary Wade Klein, Esq., Senior Attorney, Area Counsel – Atlanta Office, General Legal Services and Agent for the Director of Office of Professional Responsibility, Atlanta, Georgia, for Complainant; Thomas Edward Settles, City #1, state of "A", *Pro Se*, Respondent.

Before: Judge Hodgdon

This disciplinary proceeding was initiated against Thomas Edward Settles, an attorney and certified public accountant authorized to practice before the Internal Revenue Service (IRS), pursuant to 31 C.F.R. Part 10, Subpart D, issued under the authority of 31 U.S.C. § 330. [1] The United States Department of the Treasury, Director of the Office of Professional Responsibility, in a 14 count Complaint, alleges that Respondent failed to exercise diligence as to accuracy, as defined in 31 C.F.R. § 10.22 (1994); encouraged or advocated abusive tax shelters, as defined in 31 C.F. R § 10.33 (1994); advised clients to take positions on returns that were either frivolous and did not have a realistic possibility of being sustained, as defined in 31 C.F.R. § 10.34 (1994); and engaged in disreputable conduct, as defined in 31 C.F.R. § 10.51 (1994), and/or 31 C.F.R. § 10.51 (2002), and requests that Respondent be disbarred from further practice before the Internal Revenue Service. For the reasons set forth below, 12 of the allegations are affirmed and the Respondent is disbarred from further practice before the IRS.

[1] The regulations governing practice before the Internal Revenue Service were revised, effective July 26, 2002. This proceeding is governed by the procedures specified in the revised rules, as is the determination of the legality of conduct engaged in after July 26, 2002. The legality of conduct engaged in prior to July 26, 2002, will be determined under the regulations in effect at the time the conduct occurred. Both sets of rules can also be found in Treasury Department Circular No. 230 (2002).

Background

Settles was licensed as a Certified Public Accountant (CPA) in 1975 and went to work for Company 1. He was licensed as an attorney in the state of "A" in 1979. He was admitted to practice before the IRS as a CPA in 1975 and as an attorney in 1979. Also in 1979, Settles joined a law firm as a tax, securities, bond and estate attorney. In 1989, he opened his own law firm specializing in estate and tax planning.

In 1992, Settles began developing a tax strategy involving the transfer and lease of a taxpayer's goodwill as well as the setting up of related entities such as living trusts, limited partnerships and management companies. In 1998, he began selling this tax strategy to his clients. In 2000, the Respondent set up a website providing income tax planning information to his clients and the public.

In August 2001, Settles was notified by the IRS that his personal tax returns for 1998, 1999, and 2000 were being audited. On April 1, 2002, Settles was informed that the IRS was considering action under Section 6700, "Promoting abusive tax shelters, etc." and 7408, "Action to enjoin promoters of abusive tax shelters, etc.," of the IRS Code, 26 U.S.C. §§ 6700 and 7408, based on the tax strategy that he had developed.

In August 2002, Settles was notified that, as a result of the examination of his tax returns, changes in his 1998, 1999, and 2000 tax returns would be made. The adjustments to his income were made because of disallowance of parts of his tax strategy. In March 2003, Notices of Deficiency were issued to him for his 1998, 1999 and 2000 returns. Settles did not avail himself of his right to contest the deficiencies in the Tax Court, so on June 23, 2003, the deficiencies were assessed against him. Federal Tax Liens were filed against him on October 31 and November 14, 2003. As of the date of the hearing, these remained unpaid.

A Final Judgment of Permanent Injunction was entered by the United States District Court for the Middle District of "A" against Settles on March 24, 2003. In it, Settles was enjoined from organizing, promoting, marketing or selling his tax strategy.

In a September 3, 2003, letter, Settles was notified that civil penalties under sections 6700 and 6707, 26 U.S.C. § 6707, were being considered against him for promoting abusive tax shelters. On October 2, 2003, after a meeting on September 22, Settles was informed by the IRS that his request that the proposed section 6700 penalties be adjusted was denied. On January 5, 2004, the IRS notified him that he was being charged penalties for the tax years 1998, 1999, 2000 and 2001, for promoting an abusive tax shelter. This consisted of a penalty of $1,000.00 for each of his clients who used the abusive tax shelter. The penalties were still owed as of the date of the trial.

Settles failed to timely pay his income taxes for 2001. He also failed to timely file his 2002 federal individual tax return. Additional taxes, late filing penalties and interest were assessed against him. A Federal Tax Lien was filed against him on August 27, 2004. The amount was still owed as of the date of the trial.

On March 4, 2004, the Office of Professional Responsibility notified Settles, in accordance with section 10.60 of the Rules Applicable to Disciplinary Proceedings, 31 C.F.R. § 10.60, that disciplinary proceedings were being considered against him. Settles filed a written response on April 12, 2004. On April 28, Settles filed an Agreed Order for Voluntary Transfer to Disability Inactive Status, because of a significant hearing loss, with the Supreme Court of "A". The order was entered that same date. On April 29, he filed an Affidavit for Retired CPA/PA Status and CPE Exemption with the "A" State Board of Accountancy. In it he affirmed that he had not performed financial advisory or advice on tax matters since March 26, 2004.

The Complaint in this matter was filed by the Office of Professional Responsibility on June 18, 2004. Settles filed his Answer on July 15, 2004. A hearing was held in City #1, state of "A" on July 20, 2005. The parties have filed post-hearing proposed findings and conclusions.

Findings of Fact and Conclusions of Law

On July 13, 2005, Settles filed a document in the case entitled "Respondent's Tender of Settlement and Notice of Non-participation in Hearing." In it he stated: "The Respondent respectfully notifies the Court that he will not participate in the hearing…" In response, he was reminded of the provisions of section 10.71(d) of the rules, 31 C.F.R. § 10.71(d), that is he failed to appear at the hearing, he would be deemed to have waived his right to a hearing and be subject to a default decision.

At the beginning of the hearing, after entering an appearance, Settles made the following statement: "[A]s I provided notice to you and to Mr. Klein, I do not intend to present evidence nor do I intend to participate as a witness. I am here as an observer…" (Tr. 6.) When asked if he wanted to make an opening statement, Settles replied, "No, your Honor, just that I will not participate, since I do not have counsel." (Tr. 12.) When exhibits were offered and he was asked if he had any objections to them, he responded: "I am not participating, your Honor, so - ," or words to that effect. (Tr. 21, 29, 50.) When asked if he wanted to cross-examine the Director's witness, he stated: "No, your Honor, I repeat, I'm not participating," or similar words (Tr. 27, 99.) Finally, at the close of the Director's case, when asked if he had anything to present, he said: "I'm not participating, your Honor." (Tr. 104.)

Thus, while the Respondent technically did not "fail to appear," he did not participate in the hearing, but was present only as an observer. The Director's uncontested and unrebutted evidence clearly and convincingly establishes all but two of the charges against Settles.

The Tax Shelter

Agent 1, a Senior Revenue Agent with the Internal Revenue Service, was assigned in late 2001 to replace Revenue Agent #2 in examining Settles federal income tax returns. (Tr. 34.) Settles returns were selected for examination because a revenue agent in City #2, state of "A", had opined that Settles might be involved in selling abusive trusts. (Tr. 36.) Initially, the main issue under review was Settles' Schedule C proprietorship, particularly a claimed rent expense deduction in the form of a facility fee. (Tr. 37.) Agent 1's examination of Settles' returns later caused him to open up a "6700," promoter penalty case and a "7408," injunction case against Settles and to examine the returns of participants in the tax shelter. (Tr. 40.)

Agent 1 testified that: "What I found as I went through my examinations was that Mr. Settles and invariably almost every participant in this shelter used a similar arrangement." (Tr. 58.) He prepared a flow chart of the shelter plan which he called the "Pro Forma Flow Chart for the Settles Promotion." (Tr. Comp. Ex. 1A, p. 18.)[2] [3] He further testified that:

> [W]hat I found was that Mr. Settles organized and promoted an abusive tax shelter and that this abusive tax shelter used multiple related entities in order to substantially reduce tax, and that before and after the creation of these multiple related entities, the taxpayer continued to control – have dominion and control over the income and the assets and continued to have enjoyment of those assets.

(Tr. 58-59)

Agent 1 related that the basics of the shelter are as follows: (1) the taxpayer transfers his "goodwill," residence and automobiles to a living trust of which the taxpayer or his wife is trustee; (2) the trust then transfers the "goodwill," the residence and sometimes the automobiles to a family limited partnership (FLP) consisting of the taxpayer, spouse, any children and a general partner; (3) the spouse and children contribute nothing to the partnership for their partnership interest; (4) a management company, a corporation owned by the taxpayer, is set up as the general partner of the FLP, with a one percent interest, to manage the assets of the FLP; (5) the FLP pays the management company a management fee for managing the assets; (6) the management company hires the taxpayer, his spouse and children as employees of the company; (7) the taxpayer enters into a facilities fee arrangement with the FLP to rent back his "goodwill," residence and automobiles; (8) the taxpayer deducts from his gross receipts the facilities fee as a rent expense; (9) the facilities fee is reported as income by the FLP, but is reduced by personal living expenses of the family, such as maintenance and upkeep of the residence, real estate taxes, mortgage interest and the management fee paid to the management company; (10) the management company pays its employees a salary in the form if tax free fringe benefits, such as health insurance, split dollar life insurance and

[2] The exhibit pages are numbered with a Bates stamp, so page 18 is really numbered "000018." Only the actual page number will be referred to in this decision.

[3] A copy of the flow chart is attached as Appendix I.

tuition reimbursement; and (11) any of the rent income to the FLP that is not reduced by the facilities fee payment is distributed as income to the family members. (Tr. 59-65.)

"Goodwill," the facilities fee and the management fee are not based on "arms length" negotiations. "Goodwill" is the difference between what a well experienced person, the taxpayer, earns and what an entry-level person with no experience would earn in the same profession or occupation. (Tr. 100.) The amount of the facilities fee is determined by the value of the goodwill being "rented." (Comp. Ex. 1G at. 2495.) The amount of the management fee is generally determined by the cost of the tax free fringe benefits. (Tr. 63.)

Agent 1 testified that there are several problems with the use of this arrangement from a federal tax standpoint: (1) "the taxpayer has assigned his income to his children and to the management company in order to obtain lower federal income tax rates;" (2) "the taxpayer would be permitted through this arrangement to deduct mortgage interest, the real estate taxes, contributions on the family limited partnership, while at the same time claiming the standard deduction at the Form 1040;" (3) "personal living expenses were oftentimes deducted at the family limited partnership in the form of maintenance and upkeep of this residence. The taxpayer had full enjoyment, continued use of the residence while paying no rent to the family limited partnership for that use;" (4) the taxpayer "reduces his earned income for self-employment tax return purposes;" (5) because of "the reduced amount of income being reflected by the taxpayer certain taxpayers were able to claim the child tax credit that they would not otherwise have been permitted to claim;" (6) "[c]ertain taxpayers were able to avoid the limitations on exemptions and itemized deductions" that occur when adjusted gross income reaches a certain threshold; (8) "the management company was able to reduce by claiming fringe benefits that were not otherwise deductible." (Tr. 65-67.).

Settles 1998, 1999 and 2000 Federal Income Tax Returns

Counts 1, 2, 3 and 4 of the Complaint allege that Settles violated sections 10.22(a) and (b) (1994), 31 C.F.R. §§ 10.22(a) and (b) (1994), and sections 10.51(b) and (d) (1994), 31 C.F.R. §§10.51 (b) and (d) (1994), in connection with his 1998, 1999 and 2000 individual federal income tax returns. The evidence establishing these violations is discussed in the following paragraphs.

As pertinent to this case, section 10.22 (1994), entitled "Diligence as to accuracy," provides that:

> Each attorney, certified public accountant, enrolled agent, or enrolled actuary shall exercise due diligence.
> (a) In preparing or assisting in the preparation of, approving, and filing returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;

(b) In determining the correctness of oral or written representations made by him to the Department of the Treasury

Section 10.51 (1994), entitled "Disreputable conduct," states, in pertinent part, that:

Disreputable conduct for which an attorney, certified public accountant, enrolled agent, or enrolled actuary may be disbarred or suspended from practice before the Internal Revenue Service includes, but is not limited to:

…

> (b) Giving false or misleading information, or participating in any way in the giving of false or misleading information to the Department of the Treasury or any office or employee thereof, or to any tribunal authorized to pass upon Federal tax matters, in connection with any matter pending or likely to be pending before them, knowing such information to be false or misleading. Facts or other matters contained in testimony. Federal tax returns, financial statements, application for enrollment, affidavits, declarations, or any other document or statement, written, or oral, are included in the term information."
>
> (d) Willfully failing to make a Federal tax return in violation of the revenue laws of the United States, or evading, attempting to evade, or participating in any way in evading or attempting to evade any Federal tax payment thereof, knowingly counseling or suggesting to a client or prospective client an illegal plan to evade Federal taxes or payment thereof, or concealing assets of himself or another to evade Federal taxes or payment thereof.

Beginning in 1995, Settles used his tax strategy for his personal finances. (Comp. Ex. 1B at 73.) Hence, in addition to examining Settles' Schedules C, as noted earlier, Agent 1 also examined the Forms 1065, a partnership tax return for the family limited partnership, and the Forms 1120, a corporate tax return for the management company, filed with Settles' 1998, 1999 and 2000 tax returns. (Tr. 37.) The family limited partnership was known as LP Number 1 and the management company was known as Holding Co. Number 1. (Com. Ex. 1B at 97-99.)

The partners of LP Number 1, were the Ex-Wife's Living Trust, (20% partner) [4] Daughter #1, (29%); Son #1(20%); Step-daughter, (19%); Step-son (20%); and Holding Co. Number 1 (1%). (Comp. Ex. 1B at 74.) Ex-Wife was President of the management company, the Respondent was Secretary-Treasurer and each child was a vice president. (Comp. Ex. 1B at 77.) The Ex-Wife's Living Trust was the sole shareholder of the corporation. (Comp. Ex. 1B at 77.)

[4] Ex-wife was the Respondent's wife from 1992 until they were divorced in 2002. (Comp. Ex. 1A at 13.)

Settles claimed to have transferred his "goodwill" to Ex-Wife sometime in 1992, although there is no contract or other written document to memorialize the transfer and there was no consideration for the transfer. (Comp. Ex. 1B at 74.) The "goodwill" was derived from Settles' business as an attorney and ceased if he did not provide services as an attorney. (Comp. 1B at 83.)

Ex-Wife was supposed to have transferred her real property to the FLP in 1996, although the county land records did not show a transfer until December 13, 2001, four months after the start of the Settles' audit and even longer after the 1998, 1999 and 200 tax returns were filed. (Comp. Ex. 1B at 74.) The FLP paid the mortgage interest, taxes, utilities, repairs and upkeep, as well as for furniture and upgrades for the property. (Comp. Ex. 1B at 74.) The FLP also paid for groceries, clothing, tuition, health and automobile payments for the benefit of the Settles. (Comp. Ex. 1B at 75.) At the same time the family continued to enjoy the full use and benefit of the property as if they owned it. (Comp. Ex. 1B at 74.)

A facilities fee agreement was entered into by Settles, on behalf of his law practice proprietorship, with his wife, on behalf of the FLP, in which the proprietorship agreed to lease from the FLP: (1) Goodwill associated with Settles' law practice, (2) Office equipment, furniture and furnishings for the practice, (3) Office space, and (4) Credit support. In return Settles agreed to pay an annual facilities fee to the FLP of $150,000.00. (Comp. Ex. 1B at 75.) In 1998, the facilities fee was $113,989.00, in 1999 it was $155,250.00 and in 2000 it was $213,641.00. (Comp. Ex. 1B at 97-99.)

After he completed his audit of these arrangements, Agent 1 advised Settles that he wanted to make adjustments in his 1998, 1999 and 2000 tax returns. (Tr. 38.) Specifically, he wanted to disallow the deduction of the amount of the facilities fees for those years from Settles income. (Comp. Ex. 1B at 71.) When Settles would not agree, Agent 1 issued a 3-day letter giving Settles an opportunity to appeal the amounts. (Tr. 39.) Settles did not do so. (Tr. 39.) Consequently, in June 23, 2003, a 90-day statutory notice of deficiency was issued to Settles charging him additional tax of $552,339..00 plus interest of $15,258.61 and penalties of $13,861.53 for 1998; additional tax of $66,737.00 interest of $19,898.27 and penalties of $18,018.99 for 1999; and additional tax of $97,111.00, interest of $21,059.27 and penalties of $25,733.26 for 2000. (Comp. Ex. 4A, Tr. 39.) This notice gave Settles an opportunity to petition the Tax Court to protest the charges or the amounts, but he did not do so. (Tr. 39.) As of the date of the hearing, Settles still owed the money. (Comp. Ex. 4A.)

In adjusting Settles taxes for 1998, 1999 and 2000, the IRS concluded that the LP #1 was an abusive tax shelter. (Tr. 41.) The IRS found that:

> The family limited partnership and related corporation trust served no discernable purpose other than tax avoidance. The practical effect of the arrangement has been the transference of Settles' proprietorship net income into would be tax deductions ("Facility fees") not subject to self-employment tax, along with other unjustified tax benefits. Accordingly,

> … the purported arrangement is a sham lacking economic substance that should be disregarded for income tax purposes.

(Comp. Ex. 1B at 94.)

This determination was obviously not successfully challenged before the IRS. Nor is there any evidence that it has ever been challenged in the Tax Court, the United States District Court for the Middle District of "A", which enjoined Settles from promoting or using this tax shelter, or any other tribunal of appropriate jurisdiction. Certainly, no evidence was offered at this proceeding to rebut the IRS' conclusions. Accordingly, I find that Settles' 1998, 1999 and 2000 tax returns employed an abusive tax shelter, which was a sham lacking economic substance and resulted, at the very least, in claiming of inaccurate tax deductions.

Therefore, I conclude that Settles violated sections 10.22(a) and (b) by failing to exercise diligence as to accuracy in preparing, or assisting in preparing, approving and filing his U.S. Individual Income Tax Returns (Forms 1040) for 1998, 1999 and 2000. I further conclude that the Respondent provided false or misleading information on his U.S. Individual Income Tax Returns (Forms 1040) knowing such information to be false or misleading. Given Settles positions as an attorney and C.P.A., who specializes in tax planning, the evidence is clear and convincing that he knew, or should have known, that his scheme was illegal, which may by the reason that he has never really taken an opportunity to defend it.

<u>Settles' Advising, Encouraging, or Advocating his Clients to Purchase or Establish Abusive Tax Shelters.</u>

Counts 7, 8, 9, 10, 11 and 12 of the Complaint allege that the Respondent violated sections 10.22(a)(b) and (c) (1994), section 10.33 (1994), 31 C.F.R. § 10.33, section 10.34 (1994), 31 C.F.R. § 10.34, and section 10.51(j) (1994), 31 C.F.R. § 10.51(j), in advising, encouraging or advocating his clients to purchase, establish or take positions on returns relating to abusive tax shelters involving family living trusts, family limited partnerships and/or associated entities. As discussed below, the evidence clearly establishes these violations.

Section 10.22(c) (1994) provides that: "Each attorney, certified public accountant, enrolled agent, or enrolled actuary shall exercise due diligence:… (c) In determining the correctness of oral or written representations made by him to clients with reference to any matter administered by the Internal Revenue Service." [5] Section 10.33 (1994) entitled "Tax Shelter Opinions" requires, in pertinent part, that:

> (a) *Tax Shelter opinions and offering materials.* A practitioner who provides a tax shelter opinion analyzing the Federal tax effects of a tax shelter investment shall comply with each of the following requirements:

[5] The provisions of sections 10.22(a) and (b) (1994) are set out on page 6, *supra*.

…
…

> (3) *Identification of material issues.* The practitioner must ascertain that all material Federal tax issues have been considered, and that all of those issues which involve the reasonable possibility of a challenge by the Internal Revenue Service have been fully and fairly addressed in the offering materials.
>
> (4) *Opinion on each material issue.* Where possible, the practitioner must provide an opinion whether it is more likely than not that an investor will prevail on the merits of each material tax issue presented by the offering which involves a reasonable possibility of a challenge by the Internal Revenue Service.

Section 10.34 (1994) entitled "Standards for advising with respect to tax return positions and for preparing or signing returns" provides, in pertinent part, that:

> (a) *Standards of conduct* – (1) *Realistic possibility standard.* A practitioner may not sign a return as a preparer if the practitioner determines that the return contains a position that does not have a realistic possibility of being sustained on it merits (the realistic possibility standard) unless the position is not frivolous, and is adequately disclosed to the Service. A practitioner may not advise a client to take a position on a return, or prepare the portion of a return on which a position is taken, unless –
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> (I) The practitioner determines that the position satisfies the realistic possibility standard; or
>
> (ii) The position is not frivolous and the practitioner advises the client of any opportunity to avoid the accuracy-related penalty in section 6662 of the Internal Revenue Code of 1986 by adequately disclosing the position and of the requirements for adequate disclosure.
>
> (2) *Advising clients on potential penalties.* A practitioner advising a client to take a position on a return, or preparing or signing a return as a preparer, must inform the client of the penalties reasonable likely to apply to the client with respect to the position advised, prepared, or reported. The practitioner also must inform the client of any opportunity to avoid any such penalty by disclosure, if relevant, and of the requirements for adequate disclosure.

Section 10.51(j) (1994) proscribes: "Giving a false opinion, knowingly, recklessly, or through gross incompetence, including an opinion which is intentionally or recklessly misleading, or a pattern of providing incompetent opinions on questions arising under the Federal tax laws."

Agent 1 testified that in his investigation of the participants in Settles' tax shelter he learned several things:

> One, that most of these individuals had learned of this promotion either by word of mouth or through seminars. I learned that most of them had paid $10,000.00 to acquire or to purchase this tax shelter. I learned that they had been given what I refer to as a white binder which contained certain documents that were provided by Mr. Settles. I learned that invariably, almost every one of them had a facility fee agreement and that they had set up multiple related entities. And I also learned that Mr. Settles assisted either them or their tax return preparer and gave advice as to where certain items should appear on the tax return. And I also learned that Mr. Settles represented himself to clients as an expert in the area of income taxes.

(TR. 54-55) Agent 1 testified that almost every participant in Settles' tax shelter used a similar arrangement, which Agent 1 diagramed on a flow chart. [6] (Tr. 58, Appendix I.)

Settles issued an undated "Memo to Tax File" which he prefaced by stating:

> I have been asked by representatives of clients for whom I provided tax planning services to described the basis for my advice regarding 1) the transfer of goodwill, 2) the deduction of payments made for the use of goodwill, 3) the establishment of a partnership which may own goodwill, 4) the establishment of a regular "C" corporation as the general partner of such a partnership and 5) the adoption of tax favored fringe benefit plans by such a corporation.

(Comp. Ex. 1A at 9.) He went on to discuss all of these matters.

In the memo, Settles stated:

> In 1986, the Tax Reform Act added section 1060 to require allocation of the intangible asset of goodwill or going concern value. The committee report specifically provided that businesses that aren't active trade or businesses would also be covered by the asset allocation provisions. Subsection (c) of that section provides that the section applies to any transfer (whether directly or indirectly) of assets which constitute a business and with respect to which the transferee's basis is determined wholly by reference to the consideration paid for such assets.

(Comp. Ex. 1A at 9.) Agent 1 testified that this was incorrect because:

> Section 1060 applies to a sale of a trade or business. It requires that the buyer and the seller in the purchase and sale of a trade or business must allocate the assets, that they have acquired or sold. They must allocate the consideration, that amount that

[6] Agent 1's description of the plan is set out on pages 4-5, *supra*.

> they paid or the amount they received, to those assets. It also requires that they file with the Internal Revenue Service a statement describing this on their tax return, this sale, if you're the seller, and this purchase, if you're the purchaser, and how you allocated that consideration… [T]here was not a sale of a trade or business in these transactions…[I]t was simply an assignment of one so-called asset, that being goodwill, and… there was no consideration paid for this assignment.

(Tr. 69.)

Settles wrote: "The case law suggests that two tests must be met to qualify rent deductions where there is a relationship between the lessor and the lessee of various kinds. First, the taxpayer cannot hold title or have an equitable interest in the property; and second, a business purpose for the lease must exist." (Comp. Ex. 1A at 9.) He claimed that the shelter met the first test because: "The partnership is a legally distinct entity from the operating entity." (Comp. Ex. 1A at 9.) Agent 1 disagreed, stating that: "[T]he taxpayer did have an equitable interest in that property, not only before the assignment but also after the assignment… Secondly, … there was no economic substance nor was there any economic reality in this transfer for federal income tax purposes." (Tr. 70.)

With regard to the second test, Settles opined that:

> The *C.J. Mathews* [*sic*] suggests that in the case of a gift (or arguably a contribution to a partnership), no business purpose test applies to authenticate for tax purposes the transfer to the partnership. But the *Mathews* case suggests that four conditions must be met in the case of a gift and leaseback from a trust, the closest analogy to a gift or non-taxable transfer to a partnership and a leaseback to the operating entity:
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> 1 the grantor (transferor) must not retain substantially the same control over the property that he had before he transferred the property;
>
> 2. the leaseback should be in writing and must require payment of a reasonable rent;
>
> 3. the leaseback (as distinguished from the gift or contribution) must have a bonafide business purpose; and
>
> 4. the grantor/contributor must not retain a disqualifying "equity" in the property.

(Comp. Ex. 1A at 10.) He went on to state the four tests were met because: (1) the grantor/contributor did not serve directly as the general partner, but even if he did, "fiduciary obligations substantially alter his control;" (2) "[t]he leaseback was always in writing and required payment of a reasonable rent;" (3) the leaseback serves a valid business purpose because the lessor was not barred from continuing his business and the lessee was “assured handsome profits from rental of its goodwill asset;” and (4) the grantor/contributor did not retain a disqualifying equity in the property since there “was no requirement in the facilities fee that the lessor renew the lease for the lessee.” (Comp. Ex 1A at 10.)

Agent 1 pointed out that the tax shelter met none of these tests. With regard to the first test, he stated that: “The grantor of the transferor in these cases would be the taxpayer. And in each of these cases, the taxpayer did continue not only to have substantially the same dominion and control over those assets but continued to enjoy the benefits or the fruits of that income and those assets.” (Tr. 71.) He said that the second test was not met because the facilities fee was not a reasonable rent. (Tr.71.) Finally, he noted that “the taxpayer did have a disqualifying equity [interest] in the property, and that is that the taxpayer continued to exert dominion and control over the property, that the taxpayer continued to enjoy the benefits of not only the income but also the assets that were placed into the family limited partnership.

Interestingly, the court in *Mathews* held that taxpayers who transferred ownership of property used in the husband’s wholly owned business to a trust, and leased it back, could not deduct the rental payments from their income, noting that “before the trust’s creation Tax operated his business on and with necessary property – all under his complete control. The same was true afterward – except he hoped some of his income had been siphoned off to his children.” *Mathews v. C.I.R.*, 520 F.2d 323, 325 (5th Cir. 1975). The same is also true under Respondent’s tax shelter.

Settles set up an internet website for his business at http://www.its-your-money.com, (Comp. Ex. 1B at 303-18.) It listed a copyright of “2000 T. Edward Settles, Esq.” (Comp. Ex 1B at 303.) It began by stating: “From the top of his class to the top of his profession, attorney Eddie Settles expertly navigates the complex world of estate and income tax planning so you can keep the very most of your money.” (Comp. Ex. 1B at 303.) Under “Income Tax Planning,” the site talked about reducing taxes by spreading income over many returns or by use of a partnership, by corporations providing tax free fringe benefits to officers and employees and deducting the costs, by partnerships deducting management fees paid to corporate general partners and by the contribution of goodwill and leasing it back. (Comp. Ex. 1B at 304-05.) Under the heading “Contact Us,” it stated: “If you’d like more information about Estate Tax Planning or Income Tax Planning please contact us,” and provided an e-mail address and telephone number. (Comp. Ex. 1F at 1590.)

Thirty-four individuals, couples or businesses purchased Settles’ tax shelter. (Comp. Ex. 1A at 19-24.) All of them were audited by the IRS for using the tax shelter and all but two of them agreed, at the revenue agent or groups manager level, to changes in their returns. (Tr. 94-95.) Of the two who did not agreed, one lost at the IRS Appeals Division, had to pay the tax changes but received a settlement on the penalty, and the other involved a charitable remainder unit trust. (Tr. 94-95.) The Settles tax shelter has never been upheld by the IRS or any court of competent jurisdiction. (Tr. 95.)

A Final Judgment of Permanent Injunction was issued against Settles by the U.S. District Court for the Middle District of “A” on March 24, 2003, in *U.S. v. Thomas Edward Settles*, Case No. 3-02-1072. In it, the court made the following findings and orders:

> 3. The Court finds that Settles has consented to the entry of Judgment for injunctive relief pursuant to Code § 7402 and 7408 to prevent him from (1) engaging in conduct subject to penalty under §§ 6700 and 6701 of the Code; and (2) organizing, promoting, and selling tax packages lacking economic substance involving the use of multiple entities, including trusts, partnerships and corporations, to shelter participants’ income and to serve as vehicles for improper expenses through the manipulation of asset transfers and assignments of income.
>
> 4. It is further ORDERED, ADJUDGED, AND DECREED that Settles, individually and doing business as or through any other entity, and anyone acting in concert with him, is permanently enjoined and restrained from, directly or indirectly, by the use of any means or instrumentalities:
>
> (a) Organizing, promoting, marketing, or selling any abusive tax shelter, plan or arrangement that advises or encourages taxpayers to attempt to violate the internal revenue laws or unlawfully evade the assessment or collection of their federal tax liabilities:
>
> (b) Taking any action in furtherance of the organization, promotion, marketing, or selling of tax shelters in which participants transfer assets to trusts and partnerships, and rent those assets back for a fee; and in which the partnership pays a management fee to a participant-owned corporation to serve as general partner; and in which the corporation takes improper deductions of a personal nature;
>
> (c) Making false representations that:
>
> (I) individuals or entities may transfer or assign their income or assets to a trust or limited partnership and rent them back for the purpose of income spreading to evade federal income tax;
>
> (ii) personal expenses can be paid by a limited partnership in order to obtain tax benefits not available to others;
>
> (iii) personal expenses can be paid by a family-owned corporation in order to obtain tax benefits not available to others;
>
> (iv) individuals may report business profits through a limited partnership for the purpose of avoiding self-employment taxes;

> (v) the interests in a limited partnership may be assigned to family members through paper transactions that have no economic reality or substance;
>
> (d) Engaging in conduct subject to penalty under Code § 6700, *i.e.*, by making or furnishing, in connection with the organization or sale of an abusive shelter, plan, or arrangement, a statement Settles knows or had reason to know to be false or fraudulent as to any material matter;
>
> (e) Engaging in conduct subject to penalty under Code § 6701, *i.e.*, preparing or assisting others in the preparation of any tax forms or other documents to be used in connection with any material matter arising under the internal revenue laws and which Settles knows will (if so used) result in the understatement of tax liability;
>
> (f) Engaging in other similar conduct that substantially interferes with the administration and enforcement of the internal revenue laws:
>
> 5. It is further ORDERED, ADJUDGED AND DECREED that Settles shall notify all persons to whom he has given or sold, directly or indirectly, the tax shelter packages described herein or in the Complaint, of this injunction order

(Comp. Ex. 1I at 3105-07.)

On January 5, 2004, Settles was assessed penalties of $31,000.00 for promoting abusive tax shelters in 1998, 1999, 2000 and 2001, in violation of 31 U.S.C § 6700. (Comp. Ex. 4B.) The penalties were based on a penalty of $1,000.00 for each tax shelter. (Comp. Ex. 1A at 30-33.) As of the date of the hearing, the penalties were still due and owing. (Comp. Ex. 4B.)

Settles tax planning strategy was the same for most of his clients. As an example, the identical documents were provided to Client #1, Clients #2, and Clients #3. (Comp. Ex. 1F at 1530, 1725; Comp. Ex. 1H at 2813.) In all three he advised that income could be spread over family members by transferring personal assets to a family limited partnership and that the family owned corporate general partner could pay for personal family expenses such as health insurance premiums, disability insurance premiums, out-of-pocket payments to health care providers, dental expenses and drugs. (Comp. Ex. 1F at 1531-32, 1726-27; Comp. Ex. 1H at 2814-15.) In another example, on August 16, 2000, Settles sent a letter “To All My “A” Clients” giving the same advice concerning spreading income and payment of personal expenses. (Comp. Ex. 1H at 3060.)

In assessing Settles penalties for violation of section 6700, the Internal Revenue Service found that Settles made statements which he knew or had reason to know were false or fraudulent as to any material matter “with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of…participating in the plan." 26 U.S.C. § 6700. As the penalties still stand, the finding also still stands. That finding does not appear to have been challenged in any court and it certainly was not challenged in these proceedings.

Similarly, to permanently enjoin Settles, whether or not he consented to it, the district court had to find (1) that Settles "was involved in an abusive tax shelter," (2) that he "made statements about the tax benefits investors would received if they participated in the shelter which [he] knew or had reason to know were false and fraudulent." And (3) "that injunctive relief is appropriate to prevent recurrence of such conduct." *U.S. v. Raymond*, 228 F.3d 804, 811 (7th Cir. 2000); *U.S. v. Kaun*, 827 F.2d 1144, 1147 (7th Cir. 1987.) Settles could have contested these findings before the district court and chose not to.

I find that the clear, convincing and uncontested evidence shows that Settles: (1) Organized, promoted and encouraged an abusive tax shelter in which participants transferred assets to trusts and partnerships, and rented the assets back for a fee; and in which the partnership paid a management fee to a participant-owned corporation to serve as general partner; and in which the corporation took improper deductions of a personal nature; (2) Made statements about the tax benefits his clients would receive if they participated in the shelter which he knew or had reason to know were false and fraudulent, including representations that individuals or entities could transfer or assign their income or assets to a trust or limited partnership and rent them back for the purpose of income spreading to evade federal tax; that personal expenses could be paid by a limited partnership in order to obtain tax benefits not available to others; that personal expenses could be paid by a family-owned corporation in order to obtain tax benefits not available to others; that individuals could report business profits through a limited partnership for purpose of avoiding self-employment taxes; and the interest in a limited partnership could be assigned to family members through paper transactions that had no economic reality or substance; (3) Did not advise his clients of the material issues which involved a reasonable possibility of challenge before the IRS or of the likelihood of success if there were a challenge; and (4) Did not adequately disclose his tax scheme to the IRS before using it nor advise any of his clients to do so.

Accordingly, I conclude that Settles failed to exercise diligence as to accuracy in preparing, or assisting in the preparation of, tax returns relating to family living trusts, family limited partnerships or associated entities, or in determining the correctness of oral or written representations made by him to the Department of the Treasury or to his clients with reference to any matter administered by the Internal Revenue Service relating to family living trusts, family limited partnerships or associated entities in violation of 31 C.F.R. §§ 22(a), (b) and (c) (1994).

I further conclude that in his offerings on the internet and his written advice to his clients, Settles violated sections 10.33(a) (3) and (4) and section 10.34(a) by organizing, promoting, and selling tax packages lacking economic substance involving the use of multiple entities, including trusts, partnerships and corporations to shelter participants' income and to serve as vehicles for improper expenses through the manipulation of asset transfers and assignments of income. He knew, or should have known, that these plans had a reasonable possibility of being challenged by the IRS, that they had no realistic possibility of being sustained on the merits, that, in fact, it was more likely than not that the taxpayer would not prevail and that the plans were frivolous, having no credible basis in law or fact and were patently improper.

Settles' 2001 Taxes and 2002 Tax Return

Counts 5, 6, 13 and 14 allege that Settles violated section 10.51[7] (1994), section 10.51(d) (1994) and section 10.51(f) (2000), 31 C.F.R. § 10.51(f) (2002), for failing to timely pay the tax due on his U.S. Individual Income Tax Return (Form 1040) for 2001 and for failing to timely file his U.S. Individual Income Tax Return (Form 1040) for 2002. The evidence concerning these allegations is discussed below.

The provisions of section 10.51(d) (1994) are set out on page 6, *supra*. Section 10.51(f) (2002) is worded almost identically to section 10.51(d) (1994).

On April 15, 2002, Settles requested an extension of time to file his 2001 individual tax return. (Comp. Ex. 4A.) He evidently did not make a tax payment with the request because on June 10, 2002, he was assessed a tax payment of $5,174.35, a penalty for failing to pay taxes of $51.74 and interest of $47.85. (Comp. Ex. 4A.) He filed an amended return on July 29, 2002. On September 2, 2002, he was assessed another failure to pay tax penalty of $39.26 and interest of $37.66. (Comp. Ex. 4A.) On March 8, 2003, he filed another amended return. On August 2, 2004, he was assessed additional tax "by examination agreed audit deficiency prior to 30 or 60 day letter" of $24,017.00, plus a failure to pay tax penalty of $711.80 and interest of $2,448.91. (Comp. Ex. 4A.) As of the date of the hearing, he had a balance due for his 2001 taxes of $30,838.22. (Comp. Ex. 4A.)

Settles did not file his 2002 individual tax return until April 26, 2003. (Comp. Ex. 4A.) He filed an amended return on December 15, 2003. (Comp. Ex. 4A.) On December 22, 2003, he was assessed a late filing penalty of $2,454.65, an estimated tax penalty of $184.70, a failure to pay tax penalty of $50.09 and interest of $93.33. (Comp. Ex. 4A.) On February 9, 2004, he was assessed additional tax of $32,374.00, a late filing penalty of $8,093.50 and interest of $1,559.29 (Comp. Ex. 4A.) However on that same date, the total late filing penalty that he owed, $10,548.15, was abated. (Comp. Ex. 4A.) On March 1, 2004, the failure to pay tax penalty of $50.09 and interest of $325.51 were abated. (Comp. Ex. 4A.) On August 2, 2004, $1,203.00 "additional tax assessed by examination agreed audit deficiency prior to 30 or 60 day letter" was assessed (Comp Ex. 4A.) As of the date of the hearing, Settles had a balance due on his 2002 taxes of $34,988.81 (Comp. Ex. 4A.)

[7] The Complaint actually alleges a violation of 31 C.F.R. § 10.50 (1994), however since that is entitled "Authority to disbar or suspend" and section 10.51 governs disreputable conduct, I am assuming the Director meant to charge a violation of section 10.51, not section 10.50.

Count 5 alleges that Settles failed to timely pay the tax due on his federal income tax return for 2001 and his failure to do so constituted disreputable conduct under section 10.51 (1994). Count 6 charges that the same conduct violated section 10.5(d) (1994). The counts both charge a failure to timely pay taxes, not that Settles evaded or attempted to evade the payment of taxes, the terminology in 10.51(d) (1994). Consequently, I find no violation of 10.51(d) (1994) and will dismiss Count 6.

On the other hand, section 10.51 (1994) provides that disreputable conduct "includes but is not limited to, the acts set out in paragraphs (a) through (j), a recognition that any attempt to itemize every conceivable example of disreputable or incompetent conduct would be misadvised, if not impossible. Further, I note that section 7203 of the Internal Revenue Code, "Willful failure to file return, supply information, or pay tax" makes it a criminal misdemeanor for willfully failing to pay a tax. 26 U.S.C. § 7203. Therefore, I find that failure to pay tax when due is included within the disreputable conduct proscribed by section 10.51 (1994). Accordingly, I conclude that Settles engaged in disreputable conduct in failing to timely pay his 2001 taxes.

Count 13 alleges that Settles engaged in disreputable conduct under section 10.51(f) (2002) because he failed to timely pay his 2001 Federal individual income tax after the issuance of the July 26, 2002, version of Circular 230. This charge cannot be sustained for two reasons. First, like Count 6, there is no allegation that Settles evaded or attempted to evade payment of taxes as prohibited by 10.51(f) (2002). Secondly, I have already concluded that Settles engaged in disreputable conduct by not paying his 2001 taxes under 10.51(d) (1994). I fail to see how the issuance of Circular 230 makes this a new and distinct offense. Thus, I find no violation of 10.51(f) (2002) and will dismiss Count 13.

Count 14 charges that Settles failed to timely file his U.S. Individual Income Tax Return (Form 1040) for 2002 and his failure to do so constituted disreputable conduct under 10.51(f) (2002). Willfully failing to make a federal tax return is the first thing mentioned in the section. Accordingly, I conclude that Settles engaged in disreputable conduct under 10.51(f) (2002) when he failed to timely file his 2002 tax return.

Conclusion

Settles, an attorney, certified public accountant and self-proclaimed income tax planning expert devised an abusive tax shelter to shelter income and reduce the payment of federal income taxes. He used the strategy for his own taxes beginning in 1995 and later began marketing it to others for their use. On examination, the Internal Revenue Service found that Settles tax shelter was a sham and assessed him additional taxes for 1998, 1999 and 2000. In 2003, the U.S. District Court found that the shelter was fraudulent and enjoined Settles from organizing, promoting or selling the plan. In addition, after further investigation, the IRS assessed section 6700 penalties against Settles based on the number of people to whom he has marketed the program and who used it. Because he was still using the shelter at the time all of this was being investigated, Settles failed to timely pay his 2001 income taxes and was late in filing his 2002 tax return.

Some of the violations in this case require a showing that the Respondent acted "willfully." With regard to these violations, willfulness "simply means a voluntary, intentional violation of a known legal duty." *U.S. v. Pomponio,* 429 U.S. 10, 12 (1976). Settles was a tax practitioner of long standing; I find it hard to believe that he did not know the requirements set out in the "Duties and Restrictions Relating to Practice Before the Internal Revenue" both in the 1994 version and the 2002 version. Further, I take judicial notice of the IRS Form 2848, Power of Attorney and Declaration of Representative, which requires the practitioner, every time he represents someone before the IRS, to acknowledge that he is aware of the duties and restrictions relating to practice before the IRS. I have no doubt that Settles' violations were voluntary, intentional violations of standards of which he knew or should have known.

The evidence in this case is clear, convincing, unchallenged and unrebutted. Settles presented no evidence at the hearing. He did not cross-examine any of the witnesses. He did not object to any of the exhibits. The arguments he makes in his briefs are based, not on the evidence at the hearing, but on a motion for summary judgment, consisting mainly of Settles' self-serving affidavit, that was made before the hearing. Neither the motion nor any of the exhibits accompanying it are evidence in this matter.

At the close of the hearing, Settles stated that "the purpose [sic] that I haven't participated is, I can't represent myself when I can't hear." (Tr. 105.) As he has through much of this case, Settles waited until the hearing was concluded, and he could not be challenged, to present an argument. He made no mention of his hearing problem when he filed his notice of non-participation prior to the hearing, nor when he announced at the beginning of the hearing that he would not participate. Despite his failure to raise the issue, efforts were made at the beginning to accommodate his problem, from looking into the possibility of his using earphones, to positioning counsel, to moving his table closer to the witness stand, to trying an amplified audio system. (Tr. 1, 8, 12015.) Nonetheless, since he had announced that he was not participating, making sure that he could hear was not deemed critical to proceeding with the hearing. Had he raised the issue at the beginning, greater efforts would have been made to insure that he could hear. By waiting until the close of the hearing, I hold that he waived any complaint of not being able to hear.

Sanction

For most of his career as an attorney and certified public account, Settles has practiced before the Internal Revenue Service. In the 1990's he developed a patently fraudulent tax strategy to avoid paying the taxes he would normally have owed. He first did this with his own taxes and then marketed the scheme to other taxpayers, to encourage and advise them to defraud the government. Clearly, one who seeks to undermine the tax system should not be permitted to practice before the agency administering that tax system. The use and marketing of the abusive tax shelter requires nothing less that the ultimate sanction of disbarment.

Order

Based on the foregoing, it is ORDERED that Counts 6 and 13 of the Complaint are DISMISSED, that Counts 1 through 5, 7 through 12 and 14 are AFFIRMED, and that Respondent, Thomas Edward Settles, be DISBARRED from practicing before the Internal Revenue Service.[8]

T. Todd Hodgdon
T. Todd Hodgdon
Administrative Law Judge

[8] In the absence of an appeal to the Secretary of the Treasury, or review of the decision on motion of the Secretary, this decision will become the final decision of the agency 30 days after the date of it issuance. 31 C.F.R. § 10.76(b). Any appeal must be filed within 30 days of the date of this decision, must be filed with the Director of Practice in duplicate, and must include exceptions to the decision and supporting reasons for such exceptions. 31 C.F.R. §10.77.